CALIFORNIA
BUDGET PROJECT

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What Makes a Good Tax System?

A good tax system should:[1]

1. Raise appropriate and timely revenues.

The basic function of a state's tax system is to raise sufficient revenues to support public services. What constitutes an appropriate level of public services is a political decision and a state's tax system should fund these decisions, but not determine them. A tax system should reflect both the cost of funding public services over time, as well as taxpayers' ability to pay.

2. Be stable and certain.

A good tax system should be sufficiently stable in order to prevent the need for spending reductions in the event of unanticipated shortfalls. Making certain spending or tax reductions contingent on available revenues; establishing a budget reserve or "rainy day" fund; and engaging in cautious revenue estimating can help ensure stability. A tax system that is balanced between high growth, but volatile, and slow growth, but stable, revenue sources can help ensure stability. Broad-based tax systems, with few deductions and exclusions, also encourage stability and allow policymakers to adjust tax rates in small increments when additional revenues are needed.

3. Distribute the burden of paying for public services equitably.

A good tax system should provide consistent treatment to similarly situated taxpayers and be related to taxpayers' ability to pay. The burden of taxation should be considered over the state's entire system, not just a single tax. California's personal income tax, for example, is highly progressive. That is, higher income households pay a larger share of their income in tax. The state's sales tax, however, is strongly regressive and lower income households pay a larger share of their income in sales taxes than do higher income households. Overall, California's low-income households pay a larger share of their income in state and local taxes than do their higher income counterparts. A good tax system should provide a level playing field for business. California's property tax law, for example, provides preferential treatment to businesses that are long-term property owners relative to new entrepreneurs. Businesses should be treated equitability regardless of their form of ownership.

4. Promote economic efficiency and growth.

A good tax system should not affect taxpayer's decisions between products, services, or modes

[1] This section is largely drawn from the National Conference of State Legislatures and National Governors' Association *Financing State Government in the 1990s*, edited by Ronald Snell.

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of production. A tax system that provides incentives for some economic activities (i.e., manufacturing), but not others, leads to decision-making that may be inefficient in the marketplace. Tax incentives are inefficient because they generally provide benefits to taxpayers that would have engaged in a particular activity even in the absence of an incentive. Where preferences are granted, they should be explicit. Research suggests that taxes are more effective in discouraging certain activities (i.e., smoking) than in encouraging them.

5. Easily administered.

Tax policies that are complex add to the cost of administration and contribute to the public's perception that taxes are unfair. A good tax system should minimize taxpayers' cost of compliance, minimize the state's costs for administration, facilitate enforcement and discourage evasion, and reinforce public confidence in the fairness of the state's tax system.

6. Ensure accountability.

The tax policy choices should be explicit, rather than hidden in obscure features of a state's tax system. Tax incentives that are hidden or which provide benefits to narrow groups of taxpayers, favored industries, or a limited number of firms discourage accountability. An accountable tax system also links responsibility for raising revenues to credit for spending it. California's tax system, which vests substantial revenue raising responsibility to the state level while delegating many decisions to local governments, discourages accountability.

Accountability can be encouraged by establishing performance standards to ensure that incentives result in promise of benefits, sunsetting tax expenditures to allow periodic review, and strong tax expenditure reporting requirements.